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Person To Contact:

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July 14, 2008

LEGEND

Taxpayer =

Product 1 =

Product 2 =

Dear :

This is in response to a request for a ruling dated March 12, 2008, and subsequent correspondence, submitted on behalf of Taxpayer by your authorized representatives. The ruling concerns whether certain royalties are active business computer software royalties under §§ 543(a)(1)(C) and 543(d) of the Internal Revenue Code. The relevant facts as represented in your submission are set forth below.

Taxpayer develops software (Product 1 and Product 2) that improves basic quality and enables in ,

, and and . The software enables to be stored efficiently within the limited storage capacity of a allowing a high quality while saving space on the for other content. Taxpayer's software takes the form of an algorithm based blueprint that is translated to C code, which is the source code for most computer programs. C-code is machine readable code that causes a computer to perform a desired function or set of functions. Taxpayer's source code is licensed and delivered to Taxpayer's customers. Taxpayer's customers generally convert Taxpayer's source code into object code for use in their own products.

Taxpayer uses two licensing models when licensing its software to licensees. The first licensing model is a two-tier model whereby Taxpayer's C-code software is first provided under license to semiconductor manufacturers who incorporate Taxpayer's software in semiconductor chips as integrated circuits (implementation licensees). The implementation licensees pay an initial fee for the software they choose to license. The implementation licensees then sell their integrated circuits to pre-approved manufacturers of _____, which hold licenses to use Taxpayer's software (system licensees). The system licensees are separately licensed to make and sell _____, such as _____, _____, _____, and _____ that incorporate integrated circuits purchased from implementation licensees. Sales of _____ incorporating Taxpayer's software by system licensees generate royalties for Taxpayer generally based on the number of the units shipped by the system licensees.

Under the second licensing model, Taxpayer licenses its software to independent software vendors and _____ that act as combined implementation and system licensees (dual licensees). Taxpayer's software is incorporated into software applications such as _____ used in desktop or notebook computers. Dual licensees that manufacture integrated circuits themselves incorporate Taxpayer's software into their _____. In these cases, the implementation and the system licensees are one in the same. Accordingly, with dual licensees, the software that will be embedded in the _____ is compiled directly from Taxpayer's C-code software. As with the first licensing model, the dual licensees pay Taxpayer an initial administrative fee for the C-code and pay royalties to Taxpayer based on the number of units shipped to their customers.

Taxpayer represents that it is engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software. Taxpayer further represents that it meets the tests provided in §§ 543(d)(3), (4), and (5).

Ruling Requested

Taxpayer requests a ruling that any royalties received by Taxpayer from the licensing of Product 1 and Product 2 are active business computer software royalties for purposes of §§ 543(a)(1)(C) and 543(d).

Law and Analysis

Section 541 imposes for each taxable year on the undistributed personal holding company income (as defined in § 545) of every personal holding company (as defined in § 542), a personal holding company tax equal to 15 percent of the undistributed personal holding company income. Under § 542(a), a personal holding company

means any corporation (other than a corporation described in § 542(c)) if at least 60 percent of its adjusted ordinary gross income (as defined in § 543(b)(2)) for the taxable year is personal holding company income (as defined in § 543(a)), and at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals.

Under § 543(a)(1), personal holding company income means, in part, the portion of the adjusted ordinary gross income that consists of royalties (other than mineral, oil, or gas royalties, or copyright royalties). However, § 543(a)(1)(C) provides an exception for active business computer software royalties (as defined in § 543(d)).

Section 543(d)(1) defines the term “active business computer software royalties” to mean any royalties received by any corporation during the taxable year in connection with the licensing of computer software, which meet the requirements of § 543(d)(2), (3), (4), and (5).

Under § 543(d)(2), the royalties described in § 543(d)(1) must be (A) received by a corporation engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software, and (B) are attributable to computer software which is developed, manufactured, or produced by such corporation (or its predecessor) in connection with the trade or business described in § 543(d)(1)(A), or is directly related to such trade or business.

Under § 543(d)(3), the active business computer software royalties must constitute at least 50 percent of the ordinary gross income of the corporation for the taxable year. Under § 543(d)(4), the sum of the taxpayer’s deductions allowable under §§ 162, 174, and 195 for the taxable year which are properly allocable to the trade or business described in § 543(d)(2) must equal or exceed 25 percent of the ordinary gross income of the corporation for the taxable year. Under § 543(d)(5), the sum of the dividends paid during the taxable year (determined under § 562), the dividends considered to be paid on the last day of the taxable year under § 563(d), and the consent dividends for the taxable year (as defined under § 565) must equal or exceed the amount, if any, by which the personal holding company income for the taxable year exceeds 10 percent of the corporation’s ordinary gross income for the taxable year.

Under § 543(d)(6)(A), in any case in which the taxpayer receives royalties in connection with the licensing of computer software and another corporation which is a member of the same affiliated group as the taxpayer meets the requirements of § 543(d)(2), (3), (4), and (5) with respect to such computer software, the taxpayer shall be treated as having met such requirements. For this purpose, § 543(d)(6)(B) defines the term “affiliated group” as having the meaning given such term by § 1504(a).

The sole issue for us to address is whether Taxpayer’s royalties received in connection with the licensing of Product 1 and Product 2 are “received in connection

with the licensing of computer software” under § 543(d)(1). Although § 543(d) does not define “computer software,” the term is defined for purposes of other sections of the Code. For example, § 1.197-2(c)(4)(iv) of the Income Tax Regulations defines computer software as any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs, are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software.

Rev. Proc. 2000-50, 2000-2 C.B. 601, which provides guidelines on the treatment of the costs of computer software uses the definition of computer software under § 1.197-2(c)(4)(iv). Section 1.861-18(a)(3)(i) defines a computer program as a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. More recently, § 1.199-3(j)(3)(i) provides a definition of computer software for determining whether a taxpayer is entitled to the § 199 domestic production deduction for producing computer software within the United States. The definition of computer software in § 1.199-3(j)(3)(i), which is derived from the definition of that term under § 1.197-2(c)(4)(iv), defines computer software as any program or routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. Thus, for example, an electronic book available online or for download is not computer software. Computer software also includes the machine-readable code for video games and similar programs, for equipment that is an integral part of other property, and for typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, regardless of whether the code is designed to operate on a computer (as defined in § 168(i)(2)(B)).

Taxpayer has represented that it is engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software and meets the tests provided in §§ 543(d)(3), (4), and (5). We believe that it is appropriate in this case to apply the definition of computer software under § 1.199-3(j)(3)(i) to the term “computer software” in § 543(d)(1). Based upon that definition, Taxpayer’s C-code software should be considered computer software for purposes of § 543(d)(1) because it is a program that is designed to cause a computer to perform a desired function or set of functions even if the computer is an integrated circuit or other equipment.

Accordingly, based solely on the above, we rule that:

Any royalties received by Taxpayer from the licensing of Product 1 and Product 2 are active business computer software royalties for purposes of §§ 543(a)(1)(C) and 543(d).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer that requested it. Under section 6110(k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representatives.

Sincerely yours,

/Paul Handleman/

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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